

Approved For Release 2003/02/27 : CIA-RDP82-00357R000300040050-4

WASHINGTON, D.C. 20505

4 SEP 1975

Mr. James M. Frey
Assistant Director for Legislative
Reference
Office of Management and Budget
Washington, D. C. 20503

Dear Mr. Frey:

This is in response to your request for our views on the proposed repeal of Section 912 of the Internal Revenue Code which excludes from gross income certain allowances paid to civilian employees of the Federal Government serving overseas. We fully endorse the views expressed by Secretary of State Kissinger in his 12 July 1975 letter to Mr. Lynn.

This Agency is strongly opposed to repeal of Section 912 for the following reasons:

1. The overseas allowances in question do not represent additional compensation. They are intended to, and do in fact, defray necessary additional expenses incurred because of overseas service. As Secretary Kissinger points out in his letter, the Overseas Differential Act of 1960 (P.L. 86-707) which authorizes most of the allowances in question, and the House and Senate Reports on that Act, clearly reflect congressional recognition that service abroad entails expenses to employees above those which the employee would incur if stationed in the United States. The tax law has long distinguished between those allowances which represent increments to income (such as the "hardship differential") and those intended to reimburse employees for expenses incurred because of assignment overseas by the Government. These latter non-compensatory allowances include the "cost-of-living" allowance, the housing allowance, and the educational allowance. Increments to salary have traditionally been taxed. Reimbursement for extraordinary job related expenses which do not leave the employee "better off" financially have not been taxed.

- (a) Cost of Living Allowance -- This allowance offsets the difference between the cost-of-living at an expensive foreign post of assignment and the cost at Washington, D. C., leaving the employee no worse, but also no better-off than had he



remained in the United States. It simply makes the employee "whole." There is no gain in it for the employee. Taxing this differential would be inconsistent with the basic concepts which underlie the tax laws. It would be unrealistic to expect, and unjust to require, employees to pay additional taxes because prices in those parts of the world to which they are sent by their Government are higher than at home. The foreign relations business of the nation should not be conducted at the personal expense of its civil servants.

(b) Educational Allowance -- All U.S. citizens in the United States are entitled to free public education, financed by Federal, state, and local tax dollars. A Federal employee overseas must normally pay to educate his children. Where he must, the Federal Government pays him an allowance which merely compensates for this extra cost. Taxation of this allowance would mean an employee would not be fully reimbursed for this extraordinary cost, which he incurs solely because of his overseas assignment. Moreover, all employees overseas continue to pay state income taxes. The taxes of these employees continue to help finance the public school system. Taxation of this allowance, which in effect provides them the free education which their taxes support, would mean an unjust double taxation.

For those employees overseas whose states of residence do not require them to pay taxes during their absence, the saving in state taxes does not normally affect overseas educational costs. Free public education is financed by taxes paid throughout the life of the taxpayer, not only while their children are attending public school. The portion of this temporarily reduced tax liability which could appropriately be allocated as an offset to extraordinary educational expenses would be not only minimal, but also impossible to establish equitably.

(c) Housing Allowance -- This allowance is designed to offset against extraordinary housing expenses which an employee encounters as a direct result of his assignment in a foreign country. In many less developed areas of the world where the Government -- unlike business -- must maintain a substantial presence, the only alternative to grossly substandard housing is expensive housing which is very costly for lower level employees. This is reflected in the fact that most employees are expected to, and do in fact, supplement their housing allowance out-of-pocket.

An argument can be made that an employee may be somewhat better-off financially than his counterpart in the United States since he does not pay the basic housing costs he would incur living in the United States. This Agency has carefully studied this question and has concluded that while this may be true in some cases it is by no means the general rule. We found that the existence of "added compensation" in the housing allowance is at best uncertain, and if present, modest; that it would not be possible to develop a methodology to fairly quantify the compensatory value over the broad range of affected employees; and that other "hidden" costs and disadvantages which confront employees moving and living overseas offset whatever profit may be realized from the housing allowance. These "hidden" costs and disadvantages are substantial and include such costs as foregone housing investment opportunities, repair costs on rented property, and the expenses associated with changing one's residence every two or three years. (E.g. General weight limitations make it impractical simply to ship entire households from one place to another and, therefore, it is necessary to dispose of some property which still has value and to replace it at the next location.) It should be noted in this connection that the pattern of overseas rotation and assignment is such that the expenses of transplanting a household are assumed with greater frequency by Government employees than by private sector employees.

If after the Inter-Agency Committee on Allowances and Benefits completes its current review of Federal civilian overseas allowances and benefits, it is determined that there is an element of profit in the quarters allowance as it is now administered, we would endorse Secretary Kissinger's proposal to re-factor the allowance to eliminate that portion which is judged to be additional compensation. This would be preferable to taxing the whole allowance of all affected employees.

2. Repeal of Section 912 would not produce revenue but would in fact result in a net loss to the Government. It has been widely recognized that allowances would have to be increased to offset the taxes to be levied if Section 912 were repealed. In addition, there would be a substantial increase in the workload of simply recording payments in Government records, to say nothing of the increased burden of the employee/taxpayer in submitting his return and of the Internal Revenue Service in processing it. Disbursements which are now charged to expense at the overseas post would thereafter have to be transferred to headquarters for a centralized control and ultimate inclusion in the tax withholding report provided to the

taxpayer and to the Internal Revenue Service. The slight increase in revenue would not balance the cost of larger appropriations for allowances, in addition to the cost of non-productive recordkeeping at the field installation, at headquarters, in Internal Revenue Service, and on the part of the taxpayer. We would have a situation where the tax collection system would have become an end in itself, and the Federal Government would be forced to pay more for conducting its business overseas.

3. It has been suggested that taxation of these allowances is necessary to put employees of the Federal Government on an equal footing with employees of the private sector overseas. This rationale may satisfy an abstract sense of symmetry, but it rests on false premises. All Americans overseas are not, in fact, in a comparable economic condition. Overseas Americans fall into three distinct groups which have little in common other than their citizenship. These groups -- the military, the civilian services, and private business interests -- are present overseas for entirely different purposes and they live under different circumstances. Their taxation should be based on the specific position of each group.

The civilian services are present overseas to represent the foreign affairs interests of the country. This presence must be maintained in virtually all areas and countries of the world regardless of the relative costs and risks involved and without reference to the quality of economic, political or social life in different localities. The services performed produce no revenue, and the costs are controlled through appropriations. The private business presence, however, is intended only to produce profit for those who sponsor it. The presence is maintained as long as the profits are high enough to justify it; benefits to the private employee can be escalated to almost any level as long as they are below the revenues which are produced, and the cost of allowances designed to offset the extraordinary overseas living expenses of employees are usually deductible as business expenses by private corporations. When profits fall below an acceptable level, the presence is simply ended. In areas where business prospects are poor, a costly presence need not be established.

The motivation and objectives are different for each sector; compensation and incentive are also different. We know of no overseas corporation which limits their salary levels to Government pay scales. For example, a recent contract between an international American airline and a pilots' union provides for compensation as high as \$80,000 per annum. It is clear that private business interests are willing to establish compensation levels well above those of the U.S. Government. Economic reality is that these two overseas populations -- private sector employees and the civilian service -- are not in the same economic position. Government tax policy should not be based on an assumption that they are. Consequently, sections 911

and 912 of the Internal Revenue Code should be considered separately, and if section 912 is to be modified it should be on the basis of facts and not attributed to "equity" with the business community.

It should also be noted that corporations, in sending U.S. citizens abroad, normally concentrate on managerial and executive personnel. For middle level staffing, and even some managerial positions, they use local nationals who do not have to be paid allowances and salaries based on U.S. pay scales. The Government civilian services, and especially the intelligence services, cannot use foreign nationals to represent their interests. The trend toward the use of foreign nationals by corporations is being accelerated by the current economic problems, and the disparity between overseas corporate benefits and those of Government employees can be expected to widen.

The benefits and tax considerations concerning military personnel are also entirely unlike those of either the civilian services or the private business community. Except for the relatively small number of military personnel affiliated with the embassies, military forces overseas have salary structures established by Congress on the basis of their unique requirements, they operate in an entirely different environment, and are subject to entirely different control by the Congress. In many cases their presence is controlled by separate treaties which are, of course, subject to Senate approval. We defer to the DOD in the assessment of its own situation and the proposed changes, but we are convinced that the circumstances of military service are so dissimilar to those of foreign civilian life that major Government policies should not be established on the assumption that they are alike. U.S. Government policies with respect to overseas representation must make a distinction between civilians living in a foreign community and military units stationed in U.S. military bases abroad.

In sum, it is our view that consideration of any change in the present tax treatment of allowances should await completion of the current inter-agency review of overseas allowances and benefits and that a flat repeal of Section 912 at this time would be inequitable, prejudicial to the operations of the foreign affairs agencies, potentially inflationary, and without benefit to overall U.S. Government operations.

If there are inequities in the current practices, they tend to be between individuals receiving allowances who have different economic requirements rather than between Government employees and others. If there are occasional windfalls to individuals, they are matched by shortfalls

to those employees who are not adequately compensated for accepting overseas assignments. These are the expected faults in any general system with broad application. They do not in any way detract from the basic character of the allowances which is to provide an advantage to the Government, by making it possible to send well qualified personnel overseas with adequate support to perform their functions.

Sincerely,

SIGNED

George L. Cary
Legislative Counsel

Distribution:

Orig - Addressee

1 - DDA

1 - DDO

1 - OP

1 - OF

1 - Compt

1 - OLC Subject, w/basic

1 - OMB Liaison

1 - OLC Chrono

OLC: WPB: sk (3 Sep 75)

STAT

Approved For Release 2003/02/27 : CIA-RDP82-00357R000300040050-4

Approved For Release 2003/02/27 : CIA-RDP82-00357R000300040050-4